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Recent work of the Organization for Economic Cooperation and Development on the attribution of profits to permanent establishments: implications for the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Secretariat*

Summary

At its fourth session in 2008, the Committee of Experts on International Cooperation in Tax Matters, in considering the agenda for its fifth session, accepted an offer by a member of the Committee, Robin Oliver, to prepare a paper addressing some of the issues that might be relevant for the Committee's consideration of issues related to the attribution of profits under article 7 of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

The paper circulated under cover of the present note addresses recent developments at the Organization for Economic Cooperation and Development in the area of attribution of profits, and considers their possible relevance for the United Nations Model Double Tax Convention between Developed and Developing Countries and the work of the Committee.

* The views and opinions expressed in the present note are those of the author and do not necessarily represent the views and opinions of the Committee of Experts on International Cooperation in Tax Matters, the United Nations or any other organization.

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I. Introduction

1. At its fourth session in 2008, the Committee of Experts on International Cooperation in Tax Matters, in considering the agenda for its fifth session, accepted the offer of a member of the Committee, Robin Oliver, to prepare a paper on some of the issues that might be relevant for the Committee's consideration of issues related to attribution of profits under article 7 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (see E/2008/45, para. 45). That paper, submitted in the present note, addresses developments at the Organization for Economic Cooperation and Development (OECD) in the area of attribution of profits, and considers their possible relevance for the United Nations Model Double Tax Convention between Developed and Developing Countries and the work of the Committee.

2. Efforts to achieve international consensus on how to attribute profits to a permanent establishment, and therefore on determining the extent to which profits are taxable in the State in which a permanent establishment is located, started more than 80 years ago in the League of Nations.

3. The current OECD efforts, which started in 1998, constitute the most recent attempt at reducing the potential for double taxation that can arise if the home State and the host State do not agree on the same attribution of profits to a permanent establishment.

4. While there are differences between the OECD and the United Nations versions of article 7, the basic principle underlying the determination of a permanent establishment's profits is the same: one should attribute to the permanent establishment the profits which it might be expected to make if it were a distinct enterprise dealing at arm's length with the rest of the enterprise.

5. Probably the most important conceptual difficulty raised by the application of this principle relates to transfers occurring between the permanent establishment and other parts of the enterprise. To take a simple example, assume that a company resident of State R manufactures tables in State R and sells them in a store located in State S. The store is a permanent establishment of the company. Clearly, the sales are taxable in State S but it is also clear that the profits from these sales are less than the sale price. Expenses incurred outside State S must therefore be allowed in determining the profits of the permanent establishment but if the expenses incurred in State R for the purposes of manufacturing these tables are simply deducted from the sale price of the tables, all of the company's profits from the sales will be taxable in State S and none will be taxable in State R, even though this is where the tables were manufactured. In other words, no part of the profits would be attributed to the manufacturing function, a result that is clearly wrong.

6. Over the years, countries have developed different approaches for determining how profits should be attributed to a permanent establishment. The main differences between these approaches probably relate to the recognition of profits from internal transfers, to and from a permanent establishment, of capital, services, intangibles and property.

7. Historically, the extent to which the legal fiction of the "separate arm's length enterprise" provision of article 7 requires or allows these various approaches has been far from clear. What has been clear, however, is that double taxation of the

same profits can result from their application. This is why OECD started work on these issues. This work is noted below as being instructive for the work of the Committee of Experts on International Cooperation in Tax Matters in this area and as representing an approach that Member States will come across during negotiations, but not, of course, as a suggestion that the Committee's work and the United Nations Model need to be driven by the OECD work and Model.

8. OECD is currently in the process of fundamentally changing article 7 (Business profits) and its related commentary in the Model Tax Convention.

9. The revised article 7 will implement the conclusions of the report on the attribution of profits to permanent establishments, which was approved by the OECD[1] Committee on Fiscal Affairs on 24 June 2008 and represents the outcome of 10 years of work on how the "separate arm's length enterprise" provision of article 7 should be applied.

10. Because the conclusions of the OECD report reflect views on how the article ought to be applied and not on how it has been applied on the basis of the current version of article 7, the conclusions of the report are being implemented in the OECD Model Tax Convention in two stages.

11. The first stage is the revision of the existing commentary to article 7. This stage, which was completed in the 2008 updating of the OECD Model,[2] is aimed at implementing the conclusions of the report that do not conflict with the interpretation already provided in the commentary.

12. The second stage is the finalization of a completely new article 7 with related commentary changes for adoption in the next updating of the OECD Model in 2010. A draft discussion paper on a revised article 7 and related commentary was released by OECD for public consultation in July 2008.[3]

II. Article 7 of the Model Tax Convention

13. At present, article 7 of the OECD Model Tax Convention allocates taxing rights between contracting States in relation to business profits. The State in which the enterprise is resident ("residence State") is entitled to tax business profits of the enterprise earned in the state of source ("source State"). The source State is also allowed to the tax business profits of the enterprise but only if the profits are attributable to a permanent establishment in the source State (the existence of a permanent establishment is determined under article 5 of the OECD Model). The residence State is then required to give a credit or exemption for any source State taxation against the tax that the residence State imposes on the enterprise.

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[1] OECD Centre for Tax Policy and Administration, "Report on the attribution of profits to permanent establishments, 17 July 2008. Available at http://www.oecd.org/dataoecd/20/36/4103155.pdf.

[2] Ibid., "The 2008 update to the OECD Model Tax Convention, 18 July 2008". Available at http://www.oecd.org/dataoecd/20/34/41032078.pdf.

[3] Ibid., "Discussion draft on a new article 7 (Business profits) of the OECD Model Tax Convention, 7 July to 31 December 2008". Available at http://www.oecd.org/dataoecd/37/8/40974117.pdf.

14. Since the source State is only allowed to tax profits attributable to a permanent establishment, it is important to know how those profits are calculated. Paragraph 2 of article 7 sets out an arm's length rule for determining the amount of profits attributable to a permanent establishment. The profits to be attributed under paragraph 2 by both the residence State and the source State are considered to be:

> "... profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

15. The general approach to profit attribution under the present article 7 is to start with the branch accounts and to make adjustments as necessary to ensure an overall arm's length amount of profit is taxed in the permanent establishment.

16. Actual expenses or costs incurred by the enterprise on behalf of the permanent establishment in deriving the gross income of the permanent establishment are deductible, whether incurred directly for the purposes of the permanent establishment (e.g. the salary of a person who works exclusively at the permanent establishment for the benefit of that permanent establishment) or indirectly for the benefit of the permanent establishment (e.g. head office expenses). No head office markup of costs is permitted, except in certain cases.

17. Furthermore, except in limited cases (such as loans between branches of a bank) the present article 7 and commentary do not recognize internal dealings between the permanent establishment and head office or the permanent establishment and another part of the enterprise which would give rise to notional dividends, royalties or interest from the permanent establishment to that other part of the enterprise, or vice versa.

III. Report on the attribution of profits to permanent establishments

18. The 2008 OECD report is comprised of four parts. Part I, General considerations, sets out the general framework for the new approach to attribution of profits. Parts II to IV of the report focus on banking, global trading and insurance, respectively.

19. The central aim of part I of the report is to take the concept of treating the permanent establishment as a separate entity a good deal further than does the present article 7. The idea is to achieve a greater level of consistency between the taxation of branches and the taxation of subsidiaries under treaties.

20. Under this approach, the attribution of profits to a permanent establishment will be calculated to reflect all of the activities of the permanent establishment, including transactions with independent enterprises and associated enterprises and its dealings with other parts of the enterprise.

21. Part I of the report establishes a two-step process for the attribution of profits to a permanent establishment. The first step is to hypothesize the permanent establishment as a separate legal entity using functional and factual analysis. As explained in paragraph 19 of the above-mentioned draft discussion paper, this analysis will determine:

(a) The attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;

(b) The identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;

(c) The identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;

(d) The identification of other functions of the permanent establishment;

(e) The recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognized, having passed the threshold test referred to in paragraph 23 [of the new draft Commentary];

(f) The attribution of capital based on the assets and risks attributed to the permanent establishment.

22. A core feature of this approach is a determination of whether the permanent establishment has significant people functions. Assets, risks and capital are allocated to the permanent establishment in a balance sheet approach to support those functions. The OECD report gives examples of significant people functions. For instance, in the case of internally created intangibles, paragraph 116 of part I states that:

> "The significant people functions relevant to the determination of the economic ownership of internally created intangibles are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risk associated with the development of intangible property."

23. The second step of the authorized OECD approach is to determine the profits attributable to the permanent establishment in relation to its transactions and dealings. The 1995 transfer pricing guidelines[4] are relevant for pricing transactions between the permanent establishment and associated enterprises. The guidelines are also to be applied, by analogy, to price the dealings between the permanent establishment and other parts of the enterprise.

24. Accordingly, unlike the present article 7, this approach would recognize dealings in the nature of, say, a license provided by a head office (the economic owner of the intellectual property) to a permanent establishment that is using the intellectual property. The notional license would, in turn, give rise to a notional royalty from the permanent establishment to the head office through a reduction of the profits of the permanent establishment by the amount of that notional royalty.

25. The 2008 draft discussion paper of OECD makes it clear that the separate and independent enterprise fiction (including the recognition of notional dealings and notional payments) is confined to determining the attribution of profits to a permanent establishment under article 7. In other words, in the above-mentioned

[4] Approved by the OECD Council on 27 June 1995 and published in loose-leaf form as "Transfer pricing guidelines for multilateral enterprises and tax administrations" (OECD, Paris, 1995).

example of notional royalty, the notional royalty is not to be treated as an actual royalty for the purposes of article 12 of the Model Tax Convention because there is no actual payment of a royalty for the purposes of that article. Consequently, there will be no allocation of source State withholding tax rights in respect of that notional royalty. If a jurisdiction wanted to reserve the right to tax a notional royalty or other notional payment, it would need to negotiate a special provision for inclusion in its bilateral treaty. Even then, it would need to be able to impose taxation under domestic law to give practical effect to that provision.

26. The OECD report contains a special rule for tangible property, such as equipment and immovable (real) property. In general, economic ownership of tangible assets is allocated to that part of the enterprise in which it is being used. This means that recognition of notional dealings relating to the tangible property actually used by the permanent establishment is not expected to occur very often. It should be recognized, however, that this is a general rule and that, in the proper circumstances, it might be possible to argue that tangible property, including immovable property, used by a permanent establishment has been transferred to it under a dealing giving rise to notional rental payments for the sole purposes of article 7. As is the case with royalties (see above), such payments would not be treated as an actual rent for the purposes of articles 6 and 12 of the OECD Model.

27. A number of other important issues relating to the taxation of permanent establishments arise from the OECD report. A discussion of these issues is, however, beyond the scope of the present paper.

IV. Implementation of the conclusions of the OECD report and the implications for bilateral treaties

First stage: partial implementation through revision of the commentary to article 7

28. The 2008 update to the OECD Model Tax Convention contains a revised commentary to article 7. The revised commentary is only a partial implementation of the conclusions of the OECD report: the conclusions contained in parts I to IV of the report are implemented, but only to the extent that the report does not conflict with the present commentary to article 7. This limited implementation was necessary because the conclusions contained in part I of the report constituted a reversal of the interpretation of article 7 in the present commentary.

29. In particular, the previous version of the commentary specifically provided that, subject to specific exceptions, internal dealings would not be recognized and no deduction could be made for notional payments of interest and royalties. This position is maintained in paragraph 34 of the revised commentary to article 7. Accordingly, the recognition of notional dealings and the deduction of such notional payments in the attribution of profits does not apply in relation to the present article 7.

30. The result is that much of the interpretation in the revised commentary preserves the status quo in relation to the interpretation of the present article 7 of the OECD Model and is not affected by the conclusions of the 2008 report.

31. Bilateral treaties which are based on the OECD Model and contain the former article 7 will normally be interpreted in line with the 2008 update to the OECD Model. In general terms, this means that dealings will not be recognized in determining the profits attributable to a permanent establishment.

Second stage: new article 7 and new commentary in 2010

32. The conclusions of the OECD report will be fully implemented in the OECD Model when the revised article 7 and commentary are adopted by the Committee on Fiscal Affairs. As mentioned above, a draft text of the revised article 7 and commentary was released for public consultation in July 2008. Submissions on the draft text have been received and the adoption of the revised article and commentary is scheduled for 2010, when the OECD Model will next be updated.

33. Bilateral treaties which adopt the wording of the revised article 7 will be interpreted in line with the revised commentary to the article.

V. Implications for Member States of the United Nations

34. Paragraph 3 of article 7 of the United Nations Model Double Taxation Convention between Developed and Developing Countries is more explicit than the OECD Model in disallowing deductions for notional payments, except in the case of notional interest on intrabank lending. The author has always interpreted this as making explicit that which in the OECD Model is more implicit.

35. The revised commentary to article 7 of the OECD Model therefore may have implications for countries using the United Nations Model. Because of the limited nature of the change made to the commentary in the 2008 update, this should have no substantial impact. New Zealand has noted in its observations on article 7 that it does not agree with the approach put forward on the attribution of profits to permanent establishments in general, as reflected in part I of the report on the attribution of profits to permanent establishments.

36. This observation to the commentary reflects the concerns of New Zealand with regard to the 2008 OECD report more generally and the effect that its conclusions could have on the balance between residence and source taxing rights. In particular deductions for dealings and thus notional payments between a permanent establishment and its head office could reduce source taxation. Nevertheless, this only becomes an issue of significance if countries enter double taxation agreements based on a revised article 7 of the OECD Model and is not a result of updating the commentary.